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## **Innovative Public Private Partnership Financings and Protection of the Public Interest**

### **Executive Summary**

Public Private Partnerships have long been promoted as a way for government to lower costs to users of the public infrastructure or to increase the quality of services. Over the past 30 years many sectors within the public domain have experimented with public private partnerships, including:

- Water
- Sewer
- Solid Waste
- Health Care
- Affordable Housing
- Mass Transit
- Transportation

The history of success has largely been measured by the provision of services at a cost less than the public sector could achieve. Although there have been failures, by and large the approach of utilizing the private sector to deliver public services has been successful by this measure when carefully planned and implemented with the goal of public user benefit in mind.

The recent dubbing of asset sales to the private sector as public private partnerships has largely turned these historic policy objectives on their heads. In asset sales, concessions, long term leases and monetizations done to date the historic objective of lower costs to users has been reversed to impose much higher charges on users than the public sector would have imposed in exchange for a chunk of upfront cash to help fund short term needs of the selling governmental entity.

This reversal in objectives has raised public policy concerns both about the equitable nature to users and about whether governments are receiving more value than they could obtain through a self help financing approach.

### **Background and History**

Public private partnerships are not a new vehicle for infrastructure development in the United States. These partnerships have been used for a variety of infrastructure projects prior to the recent emphasis on the transportation sector with both positive and negative results. Outside the United States Public Private Partnerships have been widely utilized in the transportation area, primarily in third world countries but also in Europe and other developed countries such as Australia. In the non-US experience the need for private capital is largely credit driven due to three primary factors:

- 1- Undeveloped local capital markets that cannot support either the size of the financings or the implied credit exposures given the limited capital base of each local economy
- 2- No market for governmental enterprise finance in the manner that it exists in the United States
- 3- Lack of availability of low cost public funding through tax law at the local governmental level versus the use of tax exempt bond financing in the US

Thus the primary reasons for widespread public private partnerships around the world is primarily capital and credit driven.

In the US the Public Private Partnership experience has been most successful when there are significant technology, revenue demand or efficiency challenges rather than capital considerations given the ready availability of capital for public projects in the US and the extensive network of high quality public employees with extensive experience in the implementation of large public works and infrastructure projects.

One of the best examples of successful Public Private Partnerships is in the area of environmentally acceptable waste disposal. Beginning in the late 1970's it became apparent that continuing to rely on landfills in urban areas as the only disposal option was not good public policy. As a result there was a nationwide movement to implement waste to energy or resource recovery plants as the preferred disposal option. Since these plants required sophisticated equipment to process the waste, meet air quality standards and produce electricity it was an ideal candidate for Public Private Partnerships. Today there are over 30 large resource recovery plants that have been operating for in excess of 20 years. Many have renewed their agreements with the private operators and expect to be in operation for another 20 years. The original financing structures were generally limited to only 20 years due to market concerns about technology risk; today those risks are largely not a concern. The key to success in this sector was the sharing of risks between public and private sectors and the plants were generally delivered as design, build, operate, maintain contracts with specific risk allocation to those parties best able to take each risk. Thus, as an example, technology risk was taken by the private sector and change in law risk was taken by the public sector.

In the transportation sector there is little technology risk to share and the primary risk is the production of future revenues to pay for the cost of the road. Traditionally these risks have been low and acceptable as a public risk. Again in the US the use of revenue backed governmental bonds has been a widely accepted and easily marketable security to fund both the building of new toll roads and expansion of existing roads. US toll road authorities have a proven track record of efficient operations and have a mission of providing mobility through affordable tolls

designed only to fund the needs of the roadway system within the control of the toll road authority.

### **Along comes Chicago**

In 2005 The City of Chicago undertook a groundbreaking transaction that has brought new attention to the use of Public Private Partnerships in the transportation sector. This transaction was not the first time a public asset had been “sold” to the private sector through a lease transaction, however, it was the first time that the P3 mandate was utilized to increase costs to users rather than decrease costs through the application of improved efficiency of the private sector. The Chicago Skyway transaction (see full analysis in Appendix A) was however the first time that a public sector asset value was driven by projected future toll increases and the revenue stream was “monetized” in order to produce the price of the asset.

The Chicago Skyway transaction proved only one thing, that the capital markets would accept a long-term projection of revenue increases based upon economic indexes as a basis for financing. Previously toll roads were financed using an underlying assumption that increases would only be imposed based upon the revenue need of the toll road authority and that would be driven primarily by expectations about traffic flows and capital needs. The ability or desire to maximize the bottom line returns through compounding annual increase in tolls was never considered since the agencies that owned the toll roads were driven by a public policy mandate that treasured minimizing tolls.

### **Next Stop Indiana**

Shortly after the Chicago Skyway transaction the State of Indiana determined to sell its statewide east west toll road through a similar structure as was utilized in Chicago. Once again value was achieved through the monetization of future toll increases and a long-term lease was the structure.

In the case of Indiana new public policy issues are apparent. As compared to the Chicago deal which was basically a bridge between Chicago and the State of Indiana, the Indiana Toll Road was the sale of a 150 mile stretch of road that serves not only as a key link in the federal interstate highway system but also, like all statewide toll roads, is perhaps the most important economic development tool available to a state government. By selling this key asset to the private sector the State of Indiana has put itself at a disadvantage in spurring economic development projects along this route since every desired improvement to the toll road will have to negotiate with the new owner and every additional dollar spent will need to return profit to the private sector. Just the cost of capital for any new improvement will be at least 60% higher than it would if the road was publicly owned, never mind any other profit considerations to the operator. This gives the private sector considerable leverage in negotiations, after all its lease is not up for renewal anytime soon.

### **Protecting the Public Interest**

Despite the billions of dollars paid, the Chicago and Indiana transactions have actually shown that the private sector is not willing to overpay for toll road assets. The combination of credit discipline imposed by the lending community and the high cost of equity has assured that the valuation utilized by these private buyers is no greater than the amount of dollars that could have been generated by the public agencies undertaking the monetization financing on their own. As a matter of fact the cost of capital in today's markets for public financing is only 60-70% of the cost of a private monetization and therefore can either deliver greater value or require significantly lower toll increases.

As a result, all of the upside to the buyer from higher than expected traffic growth and tolling increases will be captured as profits to the new owners rather than as public transportation system-funding dollars. This leaves a huge amount of future cash flows on the table that could have been captured for public purposes.

Based upon publicly available information it would seem that the governmental decision makers in both cases were led to believe that the private sector would take a more aggressive view of

future traffic flows and thus be willing to pay a price higher than the public sector could achieve. In actuality this has not been the case to date. See Appendices A and B for a complete analysis.

Given the results of these two groundbreaking transactions what are the public policy implications and how can the public interest best be protected. There are several protections that can be implemented for asset monetization type of transactions that would go a long way to protecting the public interest:

- 1- The valuation of the asset should be undertaken on an independent basis that allows for the independent development of assumptions and the reasonable input of the existing toll road owner as to achievable efficiencies.
- 2- If the public toll road owner is prepared to undertake the monetization desired by the State government then a target amount of upfront payment should be identified and the public agency should be allowed adequate time to arrange a funding.
- 3- When monetization is undertaken by the public entity then any future non- monetized increases in revenues should be pledged to the public transportation system. This ***Public Ownership Dividend*** can be used to fund mass transit, freeways or other statewide transportation needs.
- 4- If public monetization is not desirable then when a private option is pursued a more sophisticated approach to procurement should be taken, including evaluating the bids based upon the length of the concession, limits on return on equity and risk sharing parameters, as well as, the value of the upfront purchase price. Around the world the “normal” concession for a private toll road does not usually exceed 30 years and in many cases is much shorter, even for to be built roads. Other factors used in the international experience include a termination of the concession when the equity returns have been achieved if that period is shorter than the original concession, thus returning the revenue producing asset to the public sector rather than allowing ongoing increases in equity returns to the private vendor.

## Summary

The Chicago and Indiana transactions are so exciting because, like Columbus, they found a new world. A world where dollars could be realized today based upon future revenue streams from what is essentially a monopoly roadway. These future cash flows are reliable since even if higher toll increases reduce traffic flows the increased traffic on free routes will only make the time advantage of the toll road even more valuable and less expensive to operate. The upfront dollars realized are highly attractive to units of government reluctant to increase gasoline or other taxes to fund transportation or other needs.

From a public policy point of view the lessons learned to date are:

In the US both the availability and the cost of publicly funded monetization is readily available at levels that were utilized in Chicago and Indiana. Until it is proven that the private sector is willing to take substantially more risk and thus produce substantially higher valuations the public option should be preferred.

In the case of existing toll road assets there is little risk and little reason to pursue the private monetization approach that doesn't capture the *Public Ownership Dividend*.

In the case of to be built toll roads the use of the private sector may be more appropriate since the projection of traffic growth and toll acceptability has more inherent risk than existing assets, however, if a public toll road authority is prepared to undertake the project and dedicate future excess revenues to the public transportation needs then that should be the preferred approach, even in those cases where the upfront dollars might be slightly less.

Among the public policy questions remaining are:

When is a toll a tax?

Is it equitable to impose a toll increase on an east/west corridor when the proceeds are used for north/south roadways? Is this a “corridor tax”?

Isn't it more equitable to charge a broad based transportation tax such as a gasoline tax or a motor vehicle ownership surcharge to pay for needed transportation infrastructure improvements?

## **Appendices**

Appendix A - *The Chicago Skyway Sale, An Analytical Review*

Appendix B – *Then there were two..Indiana Toll Road vs. Chicago Skyway, An Analytical Review of Two Public/Private Partnerships, A Story of Courage and Lost Opportunity*